

CREDIT QUALITY AFTER THE CRISIS: AN ONGOING CHALLENGE OF BANKING SECTOR IN ALBANIA

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Abstract

With increasingly development of banking system in Albania, credit quality and other specific factors, have always been a concern not only for bankers, but for all those who take part in the business world, because the default of one party can cause serious problems in the financial situation and in economic indicators of the other party. The development of the financial system has a significant impact on economic development. This impact is determined by the quality of lending, from the allocation of savings and other sources of lending to more successful projects. Recent years, Albanian banking sector is characterized by important developments that have a significant impact on the economy of the whole country. After 2007, is noticed a high growth of nonperforming loans in Albanian banking system, mainly as a result of the global financial crisis, but at the same time due to external and internal factors. The effect of the economic crisis is dominant external main factor in the growth of NPL (non- performing loans). Loan portfolio in Albanian banking system has been good until 2007. Levels of NPL have begun to grow from 2008 and continue. The main objective in this paper is to explain as credit quality in the Albanian banking system is deteriorated recent years.

Keywords : Credit quality, non-performing loans, challenges, Albanian banking system, bank loans

Preface

In the economic literature, there is a widely accepted opinion and justified by empirical studies, that the first indicator that needs an economist to assess the health of an economy is the level of its lending. Also, is argued that the first symptoms of a banking crisis are major differences between the

growth rates of lending and economic growth. This difference deforms the price of assets in the economy, after, artificially increase aggregate demand, while aggregate supply is small or shrinking. The experience in countries with high potential of absorption of financial resources, shows that businesses or individuals who focus their activity in enterprise with no high productivity, have the highest probability of not being able to return bank loans. In our economic reality is determined that the lending activity in 2013 has been decreased and in 2014 is increased only with 4,93%. During the month August of 2015, according to official data of the Bank of Albania, the total stock of bank loans, is increased with 0,17 % compared with 2014, giving hope for a possible revival of lending in the coming months. The largest contribution to the growth of the total loan stock during this period came from loans that are granted private business. The level of non-performing loans to August 2015 has reached in the level of 21%.

The classification of loans

According to BIS, the loans are classified as follows:

1. Standard Loans
2. Special mention Loans
3. Sub-standard Loans
4. Doubtful Loans
5. Lost Loans

Standard Loans: This refers to loans where borrowers are current in meeting commitments and full repayment of interest and principal is not in doubt.

Special mention Loans: Loans to incorporations, which may get some trouble in the repayment due to business cycle losses

Sub-standard loans: Loans whose interest or principal payments are longer than three months in arrears of lending conditions are eased. The banks make 10% provision for the unsecured portion of the loans classified as substandard;

Doubtful loans: Full liquidation of outstanding debts appears doubtful and the accounts suggest that there will be a loss, the exact amount of which cannot be determined as yet. Banks make 50% provision for doubtful loans;

Lost loans : Outstanding debts are regarded as not collectable, usually loans to firms which applied for legal resolution and protection under bankruptcy laws. Banks make 100% provision for loss loans.

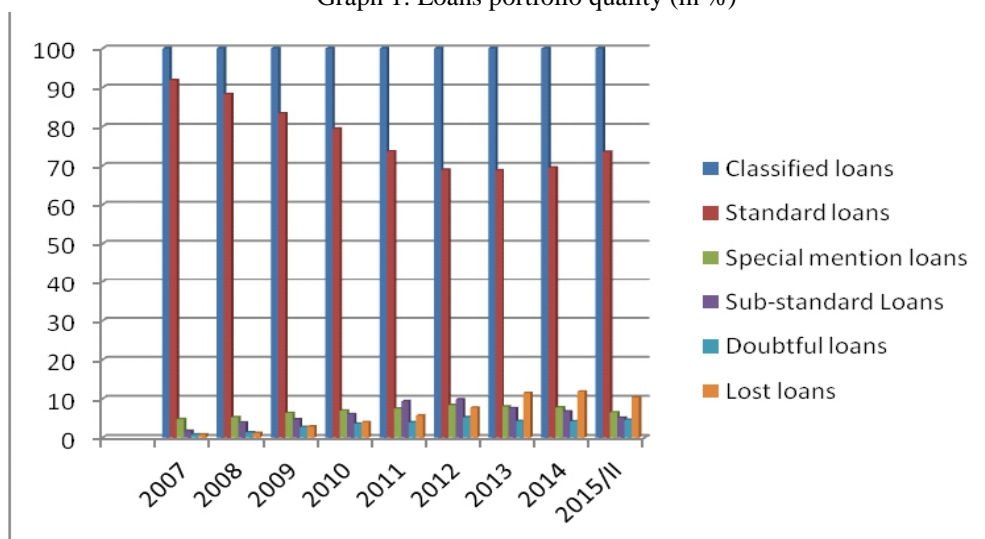
Non-performing loans comprise the loans in the latter three categories, and are further differentiated according to the degree of collection difficulties.

The weight of loans under the above categories that have changed for the period 2007-2015 is as follows:

Table 1: Loans portfolio quality (in %) *(Indicators are on annual basis)*

| Year | Classified loans | Standard loans | Special mention loans | Sub-standard Loans | Doubtful loans | Lost loans |
|---------|------------------|----------------|-----------------------|--------------------|----------------|------------|
| 2007 | 100 | 91.89 | 4.79 | 1.71 | 0.79 | 0.81 |
| 2008 | 100 | 88.31 | 5.23 | 3.91 | 1.35 | 1.2 |
| 2009 | 100 | 83.38 | 6.35 | 4.7 | 2.7 | 2.87 |
| 2010 | 100 | 79.44 | 6.94 | 6.04 | 3.59 | 3.98 |
| 2011 | 100 | 73.61 | 7.46 | 9.33 | 3.94 | 5.67 |
| 2012 | 100 | 68.91 | 8.34 | 9.83 | 5.23 | 7.7 |
| 2013 | 100 | 68.8 | 7.99 | 7.55 | 4.22 | 11.45 |
| 2014 | 100 | 69.5 | 7.74 | 6.73 | 4.20 | 11.83 |
| 2015/II | 100 | 73.48 | 6.49 | 5.12 | 4.59 | 10.32 |

Graph 1: Loans portfolio quality (in %)



Source: Bank of Albania

As can we see from the graph, the weight of problematic loans and those in special mention versus total loans is increased significantly in recent years. Significant increase have incurred lost loans, which compared with 2007 (0, 81%), are increased over eleven times in 10.32 % at the end of the second quarter of 2015. This shows that 10,32 % of them cannot be recovered by the banks, but is necessary the execution of collateral. Problematic loans total (which includes sub-standard loans, doubtful loans and lost loans) have changed according to the chart: At the end of 2014, total of problematic loans in the banking system was 22,76% split in: sub-standard

loans (6, 73%), doubtful loans (4, 20%) and lost loans (11,83%). Compared with 2007, these figures were: total of problematic loans in the banking system was 3, 31%, split in: sub-standard loans (1, 71%), doubtful loans (0, 79%) and lost loans (0, 81%). So, all categories of bad loans are increased significantly. If in 2007 nearly 92% of the loans granted by banks were classified as standard loans, already in 2015 only 73.48% of loans are standard. The growth rate of the weight of problematic loans versus total loans is worrying, because shows clearly that businesses and individuals have the high difficulties in payments, and increases the overall risk of the financial system.

Lending activity in the Albanian banking system during the period 2007 – 2015

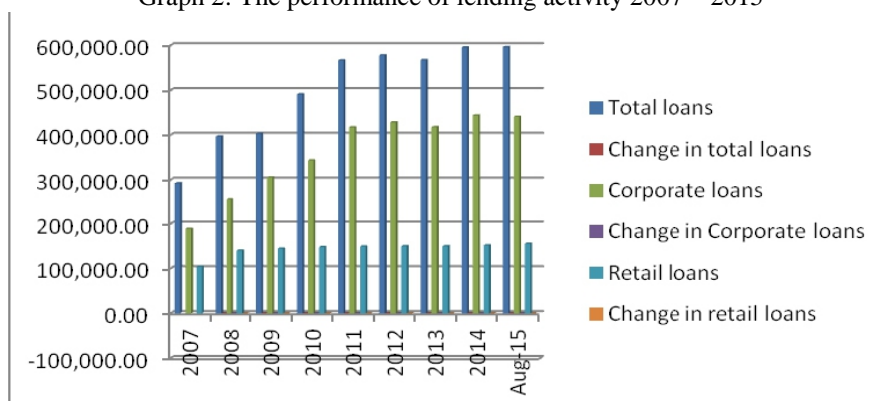
Lending activity in Albania has been increased in these years which has resulted approximately in 2014, about 44% of GDP. Total of lending in the month of August 2015 represents 45 % of total of banking assets in Albania, where in December 2007 was 39.37% and if we compare since 2003 has been only 14%.

The performance of lending activity for the corporate loans and for the retail loans for the period 2007-2015 is as follow:

Table 2: The performance of lending activity 2007 – 2015 *(the data are in million ALL)*

| Year | Total loans | Change in total loans in % | Corporate loans | Change in Corporate loans in % | Retail loans | Change in retail loans in % |
|-------------|--------------------|-----------------------------------|------------------------|---------------------------------------|---------------------|------------------------------------|
| 2007 | 292,458.60 | - | 188,645.50 | - | 103,813.10 | - |
| 2008 | 396,768.30 | 35.67 | 256,712.50 | 36.00 | 140,055.80 | 34.91 |
| 2009 | 403,204.20 | 1.62 | 305,417.60 | 18.97 | 144,473.60 | 3.15 |
| 2010 | 490,869.70 | 21.74 | 343,116.70 | 12.34 | 147,752.90 | 2.27 |
| 2011 | 566,217 | 15 | 417,344 | 21.63 | 148,873 | 0.75 |
| 2012 | 577,816.00 | 2.05 | 428,309.10 | 2.62 | 149,506.90 | 0.42 |
| 2013 | 567,159.50 | -1.84 | 417,498.70 | -2.52 | 149,660.90 | 0.10 |
| 2014 | 595,138.30 | 4.93 | 443,633.10 | 6.25 | 151,505.20 | 1.23 |
| Aug-15 | 596,195 | 0.17 | 440,781 | -0.64 | 155,413 | 2.57 |

Graph 2: The performance of lending activity 2007 – 2015



Source: Albanian Association of Banks

We look from the chart above, that total loans after 2011 have had a very small increase, except the period 2012 - 2013 which has been decreased. Also, after this year, and corporate loans are increased very little, except periods 2012 - 2013 and from 2014 to August 2015, are been decreasing. While, retail loans except 2008 that has been increased approximately 35%, in the coming years until August 2015, the growth has been very low.

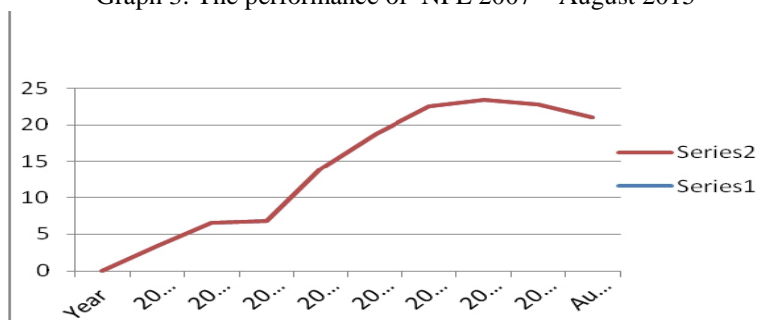
The quality of loan portfolio from 2007 to 2015

The quality of the loan portfolio in the Albanian banking system has been good until 2007. The level of non-performing loans started to increase since 2008 and ongoing. The level of NPL is increased from 3, 4 % at the end of 2007 to 22, 8% at the end of 2014, in an almost stable model of growth. In August 2015, Bank of Albania has reported a level of NPL of 21 %.

Table 3: The performance of nonperforming loans from 2007 to August 2015

| Year | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | Aug-15 |
|-----------------------------------|------|------|------|------|------|------|------|------|--------|
| Problem loans / Total loans ratio | 3.4 | 6.6 | 6.8 | 14 | 18.8 | 22.5 | 23.5 | 22.8 | 21 |

Graph 3: The performance of NPL 2007 – August 2015



Source: Albanian Association of Banks

As we look at the chart above, the level of NPL has been increasing from 2007 to 2013, but after 2013, we look that has a tendency to decrease.

The treatment of nonperforming loans from Bank of Albania

As we mentioned above, the level of non-performing loans ratio is still considered high. The dynamics of the performance of non-performing loans during the period, is reflected to increase provisions for credit risk by the banking sector. High collateralization of NPLs, gives banks the opportunity to recover its value, but a final concentration of collateral to "immovable property", as well as inefficiencies of the functioning of that market during the execution of duty (collateral) , complicate the process and make it unsafe. On the other hand, expectations of economic agents have not yet factored an acceleration of economic growth, making their plans for consumption and investment to be suppressed. The need for a faster economic growth, is highlighted as an important factor and by the banking industry for the expansion of financial intermediation.

For these reasons, the supply and the demand for loans remain below their potential, highlighting the difficulties that affect in the process of resolving of problem loans.

In these conditions, the Bank of Albania

1. It will require by banks to maintain the best possible levels of capitalization and liquidity of activity, while evidencing as accurately non performing loans.

2. It will monitor and follow the implementation of the action plan approved together with the Government reducing the level of problem loans, focused on the legal and regulatory improvements.

3. It will retain close communication with the banking industry, to assess problems that can be displayed within the administration of collateral, to identify necessary actions to improve the process;

Conclusion

1. Banks need to ask from reputable companies their audited financial statements, when these companies want to be credited with high amounts.

2. Banks should focus mainly on small loans.

3. Banks should improve mechanisms for the prevention and detection of fraud.

4. The macroeconomic situation in Albania is an important factor in the accumulation of new problem loans.

5. The growing number of problematic loans is a testimony of the difficult economic conditions that businesses and consumers are actually.

6. Despite positive developments in the banking system, the banks claim to play a more important role in future economic development.
7. Bank of Albania will monitor and follow the implementation of the action plan approved together with the Government reducing the level of problem loans, focused on the legal and regulatory improvements.
8. Bank of Albania will require by banks to maintain the best possible levels of capitalization and liquidity of activity, while evidencing as accurately non performing loans.
9. Bank of Albania will retain close communication with the banking industry, to assess problems that can be displayed within the administration of collateral, to identify necessary actions to improve the process.

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